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Bankers Trust Company

Report from The Economics Department

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THE CREDIT AND CAPITAL MARKETS REASSESSED

With business activity gaining momentum and coming to resemble prior economic recoveries, the outlook for the money and capital markets is undergoing a broad reassessment. So far, financial market conditions, generally speaking, have paralleled those during the initial stages of previous cyclical upturns in the economy, notwithstanding the raising of funds by the public sector on a scale heretofore never encountered. Private demands for financing, overall, have been somewhat restrained, and there has been a conspicuous rebuilding of both corporate and household liquidity; belatedly, most thrift institutions have been restoring their financial health as well. In fact, even the modest recent firming of interest rates in the face of a very heartening slowing in the price-wage advance is not without precedent, viewed historically.

Looking ahead, however, the best news on inflation undoubtedly is behind us, and private sector needs for credit are expected to be strengthening cyclically. At the same time, and in marked contrast with the past, there promises to be no significant letup in the enormous borrowing requirements of the Government in the foreseeable future. Meanwhile, the Federal Reserve appears to be set on pursuing a somewhat less accomodative monetary policy. As a result, and with the coming months also likely to see some shifts in institutional investment policies, financial markets appear to face pressures not typically seen until later on in economic recoveries.

Business Financing Corporations have cut back appreciably on their short-term borrowing so far this year, reacting to the massive rundown of manufacturing and trade inventories through the winter and the accompanying broad cutbacks in industry capital spending programs, and to the pressing need to restructure badly skewed company balance sheets. Through the first six months of 1983, commercial and industrial loans at banks, in total, registered little growth, as against a rise of roughly $25 billion in the similar period last year at the height of the recession, while the amount of nonfinancial open market paper outstanding actually declined, because of a sharp drop-off in bankers' acceptances. Only borrowing from finance companies, of the major sources of short-term business credit, has risen significantly during 1983, and this primarily because of the increased need by automobile dealers to finance floor inventories.

Corporate bond financing, on the other hand, has run considerably—nearly $14 billion in all—above a year ago; there has been a marked increase in bond issuance by manufacturing companies, banks, other service firms and even public utilities, which normally maintain a steady presence in this market. Unlike a year ago, too, the bulk of the bond financing has been here, whereas in 1982 the greatest activity was in the Eurobond market. Where the restructuring of corporate balance sheets through traditional methods has been prohibitively expensive, companies have also more frequently engaged in new financing techniques, such as "interest rate swap" arrangements, in order to obtain long-term money. Still more striking is the approximately $16 billion, on net, of new funds raised through new stock issues, common and preferred combined, in the past six months, which is a record, and an amount 4½ times greater than last year.

Business requirements for short-term credit, in all probability, will remain restrained for a few more months, what with the recovery under way in corporate profits, rising depreciation allowances and the continued slow advance of most commodity prices. Also, tax payments won't be the drain on corporate cash they were during the first half, and the fact that plant and equipment outlays are still being held in check, especially in the oil and gas industry which tends to be a large borrower, will continue to afford some financial relief. At the same time, some short-term financing will be required because instead of generating cash from the liquidation of inventories, most companies will be adding to stocks on hand in the coming months. And with the general pickup under way in business activity, trade credit almost certainly will expand more rapidly in the second half, at least until the yearend window dressing takes place.

Many companies would obviously like to obtain more long-term money, as evidenced by the $37 billion corporate bond issues currently in shelf registration. Yet, even with the step-up in private placement activity lately, bond financing in the second half is projected to total below the amount in the January-June period, owing to the prevailing level of long-term interest rates. Nor is it probable that the stock market will continue to absorb another flood of new issues, such as has thus far been brought to market. As a result, the prospective paydown by Chrysler notwithstanding, short-term borrowing by business corporations, including from banks, is likely to increase during the second half, a pattern quite in contrast with that in the 1975-76 recovery, when, as the attached table shows, bank debt continued to be reduced for quite some time after economic activity turned up.

Household Borrowing As is usual in the early stages of cyclical economic upturns, consumer borrowing already has picked up in response to increased buying of new cars and

other big-ticket items, and it seems virtually sure to be expanding rapidly in the coming months. With the burden of consumer installment debt having been substantially lightened over the past two years and employment rising, consumers are both in a better position and apparently more willing to take on short-term debt now. Consequently, it does not seem unreasonable to expect that installment debt outstanding will rise by something approaching $22 billion in the July-December period, more than triple the growth in the first six months of this year. At the same time, residential mortgage financing, which has expanded far beyond anyone's expectations as a result of the strong revival in home building and increased turnover of existing houses, should increase further, despite the recent firming in home mortgage rates and some strengthening of housing prices.

Beyond this, the year-long slackening in the growth of farm mortgage credit seemingly has run its course. And commercial mortgage lending, which has yet to reflect to any great extent the falloff in new office building, presumably will be bolstered in some measure by the step-up under way in construction of new shopping centers and other retail establishments that typically occurs in the wake of an upturn in home building. All in all, therefore, private sector financing could well total over $125 billion in the second half, about $14 billion greater than in the first six months of this year. And moving into 1984, borrowing by both business and households will be rising cyclically.

The Public Sector Public sector borrowing, moreover, will be increasing in the months ahead as well, quite contrary to the normal cyclical pattern. Tax-exempt financing, which soared during the first half, especially in the spring, as many municipal market borrowers moved to beat the June 30 deadline for issuing bonds in unregistered form, has slowed and most likely will be lower in the second half. Some investors' appetites for tax-exempt securities has undoubtedly been dulled by the heavy purchases made so far this year, and concerns arising out of the Washington Public Power Supply System (WHPPSS) default publicity may have a dampening effect elsewhere in this market. Also, issuance of municipal bonds for pre-refunding purposes, which was substantial during the first half, is interest sensitive, as are housing issues, and could well be affected by the recent uptick in interest rates.

Federal agency financing, however, after running well below last year—and below expectations—through the first half of 1983, because of reduced borrowing by both the farm credit and Federal housing agencies, is likely to be stepped up in the months ahead. With the savings and loan associations now moving more heavily into the mortgage market, the Federal home loan banks are unlikely to experience the sharp reductions in advances that characterized the first six months of this year. Similarly, the Federal land banks presumably have seen the end of the decline in demand for farm mortgage credit.

But most important is that Treasury financing stands to be considerably larger in the coming months. Though there is a difference of opinion regarding the exact size of the Government's new money requirements in the July-December period, in light of the strength of the economic recovery, everyone agrees that, for seasonal reasons and because of the largely structural nature of the budget deficit, they will be a good deal bigger than in the first half. The assumption made here is that the Treasury will have to raise around $125 billion, close to $25 billion more than in the six months just past, and over $5 billion greater than the record borrowing in the latter half of 1982, at the height of the recession. As the attached table illustrates, during 1976, the first full year of recovery following the 1974-75 recession, Government financing declined appreciably.

Supplying the Funds In the first half of this year, the heavy ongoing Treasury financing was absorbed without too much difficulty because of a step-up in purchases of Government securities by thrift institutions, life insurance companies and some pension funds, substantial buying by business corporations and sizable acquisitions for state and local government escrow accounts. But, a more important reason was the sharp increase in commercial bank takings; the banks purchased close to $40 billion, or some 40 per cent, of the net new Government securities sold in the January-June period. It seems unlikely, however, that this broad-based support will be forthcoming through the rest of this year and moving into 1984.

The thrift institutions, especially the savings and loan associations, after employing much of their strong growth in deposits to rebuild liquidity, have recently been turning increasingly to the mortgage market to implement their investment programs. The life insurance companies also are turning more toward their traditional investment media, notably corporate securities, and have stepped up their commitments for bond private placements, while displaying some renewed interest in commercial mortgage lending. With the pickup in economic activity, business corporations are unlikely to continue acquiring liquid assets as actively in the period ahead. It is also questionable whether state and local government general funds will be buying as many Governments, as it is doubtful that the volume of advance refundings will stay as high in the prevailing interest rate climate. For the commercial banks to maintain their rate of acquisitions of Treasury securities and at the same time respond to the stronger total loan demand will require the continued liberal injection of reserves by the Federal Reserve, which does not seem probable.

After the year-long surge in the stock market and with the uncertainty over the direction of bond yields, many portfolio managers of public and private pension funds may opt to build up some liquidity again and be attracted to Treasury securities. The property insurance companies should have more funds available for investment in the second half of this year, though there is little reason for anticipating any significant shift in their investment preferences towards Governments. In the past, foreign investors, official and nonofficial, were frequently large buyers of U.S. Government securities. But with the OPEC surplus having evaporated and many oil producing countries being forced to liquidate some of their holding of Treasuries, and with the dollar remaining strong, the foreign sector cannot be counted on for help today. Similarly, the prospect that a very large portion of the offerings of Govern-

ment securities in sight will have to be acquired by individual investors is not made bright by the recent fall in the personal saving rate. And the money market funds, a significant factor in the Treasury securities market a year ago, have been running down their Government securities portfolios in 1983 as they continue to shrink in size.

Interest Rate Impact Although analysis of prospective demand and supply developments is not always a reliable basis for drawing interest rate conclusions because of the importance of market psychology, nevertheless, it is significant that Treasury borrowing in the second half of this year, particularly in the final quarter, will account for around 46 per cent of total financing. This is a proportion which is not greatly below that of last year, when the economy was still in recession, and it is well above the 40 per cent share taken in the latter half of 1975 and the under 25 per cent share taken in 1976, when business activity was in the early stages of recovery. Such massive Government borrowing not only appears to rule out any significant decline in interest rates, but, as private sector demands for credit strengthen, some upward pressure on interest rates would seem to be unavoidable.

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Net Funds Raised in the Credit and Capital Markets
(in billions of dollars)

	1981		1982		1983	
	1st Half	2nd Half	1st Half	2nd Half	1st Half (est.)	2nd Half (proj.)
Nonfinancial Sectors						
Short-term						
Bank loans to business[1]	20.0	37.6	27.7	17.6	2.1	5.9
Open market paper[2]	21.1	12.0	14.9	−6.9	−1.0	2.5
Finance company loans to business	5.8	3.6	1.6	−1.7	2.5	1.8
Total business credit	46.9	53.2	44.2	9.0	3.6	10.2
Consumer installment credit	5.3	12.9	.6	12.5	6.5	22.0
Life insurance policy loans	3.5	3.8	2.7	1.7	.8	1.0
Farm credit agency loans	2.0	−.5	.3	−1.9	.8	−.5
Total other	10.8	16.2	3.6	12.3	8.1	22.5
Total	57.7	69.4	47.8	21.3	11.7	32.7
Investment						
Corporate bonds	13.6	10.3	8.2	17.3	17.5	13.5
State and local bonds	13.6	15.4	20.7	32.1	30.8	22.0
Corporate stocks	3.3	−1.0	3.5	7.9	15.8	12.0
Foreign bonds and stocks	2.0	3.2	1.0	6.8	5.0	3.5
Mortgages	62.1	53.2	41.0	43.9	61.5	65.0
Total	94.6	81.1	74.4	108.0	130.6	116.0
U.S. Government securities[3]	33.5	54.2	42.4	119.8	102.5	125.0
Total	185.8	204.7	164.6	249.1	244.8	273.7
Financial Sectors						
Open market paper	11.9	9.0	7.6	−9.5	3.8	1.5
Corporate bonds	−.2	−.7	−.7	3.0	3.8	3.0
Corporate stocks	−.1	−.1	.4	.6	3.5	1.5
Financial bank loans	3.0	4.5	−2.3	5.6	−5.5	2.0
Nonbudget agencies (FHLB, FNMA, FFCA, FHLMC)	13.0	17.3	11.0	2.9	−2.0	3.2
Total	27.6	30.0	16.0	2.6	3.6	11.2

[1] Includes both corporate and noncorporate business, domestic and foreign, and agriculture.
[2] Includes bankers' acceptances.
[3] Publicly held.

Financing Business Corporations
Major Sources and Uses of Funds

(in billions of dollars)

	1975		1976		1982		1983	
	1st Half	2nd Half	1st Half	2nd Half	1st Half	2nd Half	1st Half	2nd Half (proj.)
Uses								
Physical assets								
Plant and equipment	56.8	59.4	62.8	66.2	128.1	130.2	124.8	128.7
Inventories—book value	—2.3	4.5	13.9	13.6	—3.4	—11.4	—2.5	14.0
Total	54.5	63.9	76.7	79.8	124.7	118.8	122.3	142.7
Other uses of funds								
Liquid assets	2.8	6.2	4.2	10.4	—7.0	22.7	5.5	16.0
Investments abroad	8.3	5.8	6.2	5.4	3.7	3.7	5.3	5.5
Net trade credit	6.8	—7.3	14.5	—6.1	16.2	—14.4	15.2	—8.5
Total	17.9	4.7	24.9	9.7	12.9	12.0	26.0	13.0
Sources								
Cash flow								
Undistributed profits	18.7	28.3	30.1	38.0	21.3	19.0	16.7	28.0
Capital consumption allowances	41.3	43.0	44.2	46.5	100.5	108.0	117.0	122.0
Total	60.0	71.3	74.3	84.5	121.8	127.0	133.7	150.0
Loans and securities								
Bonds	17.7	9.5	11.4	11.4	8.2	17.3	17.5	13.5
Tax-exempts	1.5	1.5	1.1	1.9	3.3	5.6	4.9	4.0
Stocks	5.6	5.1	6.7	3.9	3.5	7.9	15.8	12.0
Bank loans	—7.3	—2.0	—1.2	6.2	24.9	20.6	1.6	5.3
Open market paper	—.9	—1.8	2.5	.2	8.8	—12.3	2.5	2.5
Finance company loans	1.7	2.1	4.5	3.9	1.6	—1.7	2.5	1.8
Total	18.3	14.4	25.0	27.5	50.3	37.4	44.8	39.1
Other sources of funds								
Direct foreign investment	1.1	1.5	2.6	1.8	3.9	5.6	4.7	4.0
Unpaid taxes	—7.3	4.8	.6	6.9	—15.4	4.5	—4.0	4.0
Total	—6.2	6.3	3.2	8.7	—11.5	10.1	.7	8.0

Net Funds Raised in the Credit and Capital Markets in 1974-76

(In billions of dollars)

	1974		1975		1976	
	1st Half	2nd Half	1st Half	2nd Half	1st Half	2nd Half
Nonfinancial Sectors						
Short-term						
Bank loans to business[1]	20.8	10.8	—8.0	—.6	—.3	5.2
Open market paper[2]	5.9	8.0	—1.4	—.9	3.6	2.3
Finance company loans to business	2.3	2.5	1.5	2.2	4.7	3.9
Total business credit	29.0	21.3	—7.9	.7	8.0	11.4
Consumer installment credit	3.6	5.9	—2.6	10.0	6.7	14.9
Life insurance policy loans	1.1	1.6	.8	.8	.7	.7
Farm credit agency loans	1.4	1.2	1.0	.5	1.7	.7
Total other	6.1	8.7	—.8	11.3	9.1	16.3
Total	35.1	30.0	—8.7	12.0	17.1	27.7
Investment						
Corporate bonds	9.1	10.6	17.7	9.5	11.4	11.4
State and local bonds	9.2	4.6	4.7	11.7	9.8	9.9
Corporate stocks	2.8	1.3	5.6	5.1	6.7	3.9
Foreign bonds and stocks	1.0	1.1	3.0	3.5	3.9	5.0
Mortgages	35.9	27.1	26.4	33.4	39.8	47.4
Total	58.0	44.7	57.4	63.2	71.6	77.6
U.S. Government securities[3]	—3.4	15.2	36.4	49.4	33.5	35.6
Total	89.7	89.9	85.1	124.6	122.2	140.9
Financial Sectors						
Open market paper	2.2	1.6	.3	.8	—.2	2.4
Corporate bonds	2.5	2.9	2.4	2.3	3.7	3.4
Corporate stocks	.3	—.2	—.6	.4	.4	.3
Financial bank loans	1.3	1.2	—3.2	1.6	—2.3	5.2
Nonbudget agencies (FHLB, FNMA, FFCA, FHLMC)	5.6	11.0	—.4	2.9	1.0	1.8
Total	11.9	16.5	—1.5	8.0	2.6	13.1

[1] Includes both corporate and noncorporate business, domestic and foreign, and agriculture.
[2] Includes bankers' acceptances.
[3] Publicly held.